

OFFICE OF THE  
UNDER SECRETARY OF STATE  
FOR ECONOMIC AFFAIRS  
WASHINGTON

*See also: Versailles  
Summit file)*

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March 24, 1982

TO: DOE, Mr. Henry Thomas  
NSC, Mr. Henry Nau  
CIA, Mr. Maurice Ernst ✓  
OMB, Mr. Fred Khedouri  
CEA, Mr. James Burnham  
OPD, Mr. Danny Boggs  
DOD, Mr. David Denoon  
Treasury, Mr. Charles Shotta

SUBJECT: Energy Security Paper for Versailles Summit

I am pleased to attach for your information a draft of a U.S. paper on energy security to be provided to the Personal Representatives of the EC who has been assigned the responsibilities of preparing a paper on energy for the Versailles Economic Summit. It is planned that this paper be discussed at next Tuesday's NSC meeting. I would be grateful to have any comments you and your colleagues may have by COB Thursday, March 25.

*William F. Martin*

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Context of the Versailles Energy Security Initiative

The United States is not receiving sufficient credit for the beneficial impact of our energy security policies. Over the past few months the U.S. Government has been criticized for taking a relatively defensive stance in international fora against artificial mechanisms like sub-crisis management. In addition, our objections to the Siberian pipeline have been met with strong European resistance. This has led some to question U.S. sincerity towards international energy cooperation.

Yet, the facts show that our policies of removing market impediments to promote fuller energy development have resulted in unprecedented energy development. There has been a dramatic reduction in U.S. oil imports which has brought about a better oil market situation benefiting all nations. While other countries have lagged behind in building oil stocks, the U.S. has used the present market situation to its advantage and doubled the Strategic Petroleum Reserve in less than a year. Our coal industry is rushing to meet not only U.S. coal demand but also that of our Allies. The President has made one of the strongest supportive statements for nuclear power of any Head of State in recent times. These developments point the way for a more positive approach to international energy policy making.

The upcoming IEA Ministerial (May 24) and Versailles Summit (June 4-6) offer us the opportunity to stress the positive aspects of U.S. energy policy, to "take the offensive" and renew our leadership role based on the principles of letting the market do its job. It is proposed that the attached paper be submitted to our Summit partners for their consideration in preparation for Versailles.

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Energy Security at the Summit

While energy today is not the front page news issue which it was at the Tokyo (1979) and Venice Summits (1980) it still remains a vital element of overall economic performance in Summit countries. Indeed, instead of a constraint on economic development, as we have viewed it in the past, energy may be a factor contributing to recovery. Lower prices for energy bring long awaited relief from inflation and pressure for higher wages and business costs. Economic recovery in turn will bring new opportunities for greater energy investment.

Without confusing optimism with complacency, the time is right to reconsider international energy imperatives in a more positive vein. There are abundant resources within the Western community and development of these reserves will bring new economic opportunities. Development of Western resources will keep energy revenues at home and create employment in the West. Energy security does not stop with energy. It should be viewed as a means to enhance OECD economies and to combat unemployment and inflation by insuring that outside vendors do not continue to take the lion's share of OECD energy payments. What is needed at the Versailles Summit is a renewal of commitment to rely primarily on market forces to develop indigenous energy resources and to diminish dependence on non-OECD sources.

Energy security objectives at Versailles should be threefold:

- (i) to underscore the importance and effectiveness of market forces in encouraging development of energy supplies and more efficient use;
- (ii) to encourage Summit countries to fully develop the rich resource base of the community of Western countries, thereby reducing dependence on insecure sources of supply; and
- (iii) to continue efforts to minimize the disruptive effects of oil and gas shortfalls and/or cutoffs from unreliable exporters.

I. Reliance on Market Forces

Experience has shown us that reliance on market principles is the most effective means to achieve long term structural adjustment of energy economies. The price increases of the last few years have significantly reduced demand for energy and, in particular, demand for oil. This illustrates most convincingly the importance of clear market signals to consumers. Likewise, production of indigenous oil, gas and

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coal has been stimulated where market forces have been allowed to function properly. Exploration activities for oil and deep (unregulated) gas are at a 20 year high in the United States. Our European partners and Japan also have a successful record relying on market forces. Energy prices have historically been high in these economies, resulting in a much lower per capita energy use than in North America, where prices have been relatively lower.

Examples abound as to the importance of the market, yet throughout the Summit countries there are still a number of cases where prices are being held at artificially low levels. Italian fuel prices (with the exception of gasoline) are held well below world levels; Canadian domestic oil prices remain below international levels; British monopolistic practices keep U.K. gas producer prices at relatively low levels (although this policy may soon change in an effort to stimulate greater exploration and production); and the United States continues to control natural gas prices. All of these conditions exist due to specific and understandable political factors and they will be difficult to change. Nevertheless, Summit countries should commit themselves to remove market imperfections and to allow domestic energy prices to reflect international levels. In areas lacking a world pricing standard, such as electricity generation, the marginal replacement costs could serve as a guideline for pricing strategies.

## II. Accelerate Energy Alternatives in Western Countries and Endorse Free Western Energy Trade

Western countries as a whole are richly endowed with energy resources. The best means for achieving long term energy security is to develop these resources to their fullest potential and to encourage freer trade in resources among Western countries. The aim should be to reduce the percentage of energy resources coming from potentially unreliable non-OECD country sources.

(i) Coal is the most abundant resource within the West. Suppliers such as Australia, Canada and the United States are in a position to meet their own growing requirements and the import needs of Western Europe and Japan. Recent experience has illustrated that the private sector is making significant progress in the development and shipping of U.S. coal, including increasing port capacity. Coal importing nations should be further encouraged to invest in mines and ports in coal producing countries, thereby enabling all countries to share in the costs and benefits of this key resource. European nations and Japan can facilitate coal trade by promoting construction of receiving terminals and adopting measures to increase coal use in industry and

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electrical generation. Producers and consumers should reaffirm the need for long term contracts that will enable sufficient private investment to realize greatly expanded coal production, use and trade.

(ii) Recent large natural gas discoveries in the U.S. (lower 48 and Alaska), Canada, Norway and the U.K. suggest that this convenient and widely accepted fuel exists in abundance within the Western community. Every effort should be made to minimize dependence on gas from the Soviet Union, replacing it where economically feasible from Western country sources. Development and transport of OECD gas reserves will not only provide a source of certain and predictable supply for years to come, but also stimulate economic opportunity and create jobs within industrialized countries.

(iii) Nuclear programs are proceeding relatively well in most Summit countries, although some nations -- notably the United States -- are lagging behind. A strong statement of support by Heads of State can help sustain the momentum of worldwide nuclear energy growth and renew confidence in those countries where programs are delayed. A commitment to strive for pricing electricity at the marginal replacement cost could help spur investment. The Summit might mandate the High Level Monitoring Group to devote special attention to nuclear energy over the next year. Heads of State should also consider asking the Nuclear Energy Agency to assess the feasibility of a joint international waste management project.

(iv) Some potentially promising energy alternatives have too long a pay back period to interest private investors. Investment in research and development of sources like fusion tend to be very expensive and a burden on individual country budgets. Summit countries could consider strengthening their cooperation by sharing expenses and expertise to expedite the development of these fuels. This could be done perhaps as part of the French (host country) focus at this Summit on new technologies.

(v) Summit countries should seek to facilitate private investment in LDC energy production, by increasing the multiplier effect of World Bank lending.

### III. Preparing for Disruptions in Short Term Energy Supplies

Despite a welcome respite from oil market turbulence, the chance of sudden and potentially major disruptions in oil supply still exists. The U.S. has reduced its vulnerability to oil supply disruptions, but Europe and Japan remain highly dependent on uncertain sources of supply. All

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Western countries would suffer from the economic and political consequences of a new supply interruption.

In addition, a dangerous blind spot has emerged with respect to the security implications of alternative sources of energy, some of which represent risks equal to that of insecure sources of oil supply (i.e., European dependence on Soviet gas). Thus, Summit countries may wish to address a number of these emergency preparedness problems.

(i) Large scale oil disruptions. The IEA and EC emergency sharing systems remain the principal international mechanism for sharing the burden of major shortfalls in oil supply. Summit countries should reaffirm their support of these systems, although individual methods of complying with the international sharing scheme should be left to the discretion of each country.

(ii) Smaller oil disruptions. Considerable effort has recently been expended to identify possible responses in the event of a 1979 type market syndrome: a relatively small shortfall resulting in a disproportionate price rise. Because it is not possible to describe accurately remedies for unknown emergencies, the U.S. has encouraged all IEA countries to increase oil stocks. Higher levels of stocks will buy time in the event of a disruption in order to meet at high governmental level and to decide what action, if any, is warranted by the circumstances. In the spirit of this premise, the U.S. has more than doubled its Strategic Oil Reserve within the last year, but other countries have unfortunately lagged behind. All countries should be encouraged to build their own stocks for their own use in times of emergency. The mere existence of these stocks should have a very positive effect in times of crisis. This focus on supply side measures would constitute a salutary corrective to the preoccupation with price and allocation schemes which waste resources. We might usefully continue discussions within the IEA/EC on how individual countries would use stocks in times of oil market disturbances. Such discussions are likely to conclude that stock sharing schemes are not workable, nor desirable. This will act as an inducement for each country to build stocks for its own use.

(iii) Natural Gas Security. Given the projected increased role of natural gas imports to Western Europe and Japan, Summit countries should develop with utmost urgency means for achieving enhanced gas security, including increased storage facilities, surge capacity in the OECD area to be tapped in times of emergency, better integration of the European gas grid and more dual-fired capacity among large industrial users. The IEA and EC should continue their efforts to coordinate these efforts so that an inter-governmental approach can be taken to complement national efforts.

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#### IV. Draft Energy Security Statement

The following text illustrates the type of agreement which might be reached by Summit countries to emphasize the points made in this paper.

##### Heads of State:

-- agreed that investment in Western energy resources can accelerate economic recovery and provide for a stable long term energy future;

-- underscored the importance of market principals in encouraging development of energy supplies and more efficient use;

-- encouraged Summit countries to develop fully the rich energy resource base of Western countries, thereby reducing dependence on insecure sources of supply;

-- noted that freer trade of energy resources within the West should be encouraged; and

-- recognized that the world economic system remains susceptible to sudden energy supply disruptions.

To realize expeditious development of Western energy resources and free trade they agreed to:

-- commit themselves to remove market imperfections and to allow domestic energy prices to reflect international levels. In areas lacking a world pricing standard, such as electricity generation, the marginal replacement costs should serve as a guideline for pricing strategies;

-- continue efforts to expand Summit country coal production, use and trade reaffirming the need for long term contracts to encourage private investment. Coal producing countries will welcome investment in mines and ports, thereby enabling all countries to share in the costs and benefits of this key resource;

-- expand Western natural gas production and trade, thereby minimizing dependence on insecure sources of supply and providing economic opportunities within the West;

-- continue efforts to expand nuclear energy worldwide and call upon the Nuclear Energy Agency to assess the feasibility of a joint international waste management project; and

-- consider ways to increase private investment in developing country energy production by increasing the multiplier effect of World Bank energy lending.

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Recognizing that the energy market remains inherently risky, Summit countries also:

-- reaffirmed their commitment to the IEA oil emergency sharing system;

-- agreed to use the present relaxed market situation as an opportunity to build strategic oil stocks and encouraged that discussions continue on how individual country stocks might be used in a minor disruption; and

-- encouraged the IEA and EC to continue their efforts to coordinate Member Country efforts to enhance Western natural gas security.

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